DEPARTMENT OF STATE REVENUE

04-20100681.SLOF

Supplemental Letter of Findings: 04-20100681
Gross Retail Tax
For the Years 2006, 2007, and 2008

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Refrigeration Equipment – Gross Retail Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b)(c); IC § 6-8.1-5-1(c); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282 (Ind. Tax Ct. 1999); USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct.1991); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); 45 IAC 2.2-5-8(b); 45 IAC 2.2-5-8(k); Webster's II New Riverside University Dictionary (1988).

Taxpayer argues that the Department erred in concluding that its "finished goods cooler" was not exempt from sales/use tax.

II. Evaporation Equipment – Gross Retail Tax.

Authority: 45 IAC 2.2-5-8(c); IAC 2.2-5-8(j); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct.1991); Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Letter of Findings 04-20100681 (June 15, 2011).

Taxpayer maintains that its purchase of evaporation equipment was not subject to sales/use tax because the evaporation equipment is directly used to produce Taxpayer's food products.

III. Auger – Gross Retail Tax.

Authority: 45 IAC 2.2-5-8(b); 45 IAC 2.2-5-8(d); 45 IAC 2.2-5-8(g); 45 IAC 2.2-5-8(k); 45 IAC 2.2-5-9(h)(2).

Taxpayer claims that its purchase of an auger was not subject to sales tax because the auger is directly used in the direct production of Taxpayer's food products.

STATEMENT OF FACTS

Taxpayer produces various food products at locations within the state and locations outside the state. The Department of Revenue (Department) conducted a "Sales and Use Tax" audit of Taxpayer's records related to one of Taxpayer's food production facilities.

During the course of the audit review, Taxpayer's representatives agreed to use a "statistical sampling methodology" to estimate the additional purchases subject to use tax. However, Taxpayer's representatives did not agree to certain adjustments contained within the statistical sample. In effect, the Department found that Taxpayer had self-assessed use tax on certain items but failed to self-assess use tax on other items which the audit determined were not exempt. This audit review resulted in the assessment of additional sales/use tax as outlined in an audit "summary" issued September 2010. Taxpayer filed a protest challenging that assessment. An administrative hearing was conducted and a Letter of Findings issued in June 2011 denying Taxpayer's protest in part and sustaining Taxpayer's protest in part.

Taxpayer objected to the Letter of Findings indicating that it "disagree[d] with all of the Department denials of protested items...." However, Taxpayer's "additional information and arguments" related to three specific issues which were discussed in a subsequent administrative hearing. As a result of that hearing, this Supplemental Letter of Findings results.

I. Refrigeration Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer purchased a "work-in-process" cooler and a "finished goods cooler." Taxpayer argues that it was not required to pay sales tax at the time it purchased this refrigeration equipment and was not required to self-assess use tax on the ground – as stated in Taxpayer's original protest – that the equipment "has an immediate and direct effect upon the articles being produced...." Taxpayer explains that the equipment acts by "lowering the temperature of the [food product] as close to the point of freezing without freezing the product." Taxpayer concluded that the "coolers are the final steps of an integrated process...."

The audit report addressed Taxpayer's refrigeration equipment as follows:

> [Taxpayer's] refrigeration consists of a work in process cooler, which comprises 30[percent] of the system, and a finished goods cooler, which comprises 70[percent] of the system. The finished goods cooler is located in the storage areas, in which completed product must be held for 24 hours before being shipped to customers. Therefore, the [Taxpayer's] refrigeration system was considered to be used 70[percent] of the time in taxable operation within the facility.

The Department's audit found that the Taxpayer's refrigeration system – consisting of the "work-in-process" cooler and the "finished goods cooler" – was used in an exempt manner and a non-exempt manner. The audit found that the "work-in-process" cooler was exempt and the "finished goods cooler" was not exempt.

The June 2011 Letter of Finding denied Taxpayer's protest stating that the "'finished goods cooler' does not act upon the Taxpayer's food product to cause a further 'transformation' of that food product." The Letter of Findings did not disagree with Taxpayer's contention that the finished goods cooler was necessary but pointed out that the exemption is not based on sheer necessity.

The fact that particular property may be considered essential to the conduct of manufacturing because its use is required either by law or by practical necessity does not mean itself the property " has an immediate effect upon the article being produced." Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property. 45 IAC 2.2-5-8(g). (Emphasis added).

Taxpayer objects finding that both the audit's conclusions and the June 2011 Letter of Finding "rely entirely on semantics for finding the 'finished goods' cooler is taxable."

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Rhoade, 774 N.E.2d at 1047; USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax. Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Rhoade, 774 N.E.2d at 1048. A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property. Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

However, Taxpayer presumably believes its finished goods cooler is exempt from both sales and use tax pursuant to 45 IAC 2.2-5-8(b) which states as follows:

> The state gross retail tax does not apply to sales of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property. (Emphasis added).

In particular Taxpayer cites to 45 IAC 2.2-5-8(k) as authority for its position that the refrigeration equipment – in particular the "finished goods cooler" – is entirely exempt. The cited regulation states as follows:

> "Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product having a distinctive name, character, and use. Operations such as compounding, fabricating, or assembling are illustrative of the types of operations which may qualify under this definition.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." Indiana Dep't. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

45 IAC 2.2-5-8(b) like all tax exemption provisions, is strictly construed against exemption from the tax.

Tri-States Double Cola Bottling Co. v. Dep't of State Revenue, 706 N.E.2d 282, 283 (Ind. Tax Ct. 1999); Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 636 (Ind. Tax Ct. 1999).

Taxpayer's position is that the finished goods cooler is directly used in the direct production of Taxpayer's food product and, as a result, is not subject to sales/use tax. See 45 IAC 2.2-5-8(b). In order to qualify for this sought-for exemption, Taxpayer's finished goods cooler must be "directly involved" in the "direct production" of its food product. As noted, 45 IAC 2.2-5-8(k), states that there must be a "change in form, composition, or character different from that in which it was acquired."

Taxpayer argues that the Department's determination distinguishing between Taxpayer' work-in-process cooler and the finished goods cooler is based on "semantics." ("The study or science of meaning in language forms [especially] with regard to historical changes." Webster's II New Riverside University Dictionary 1060 (1988)). As noted, sales tax exemptions are "strictly construed against exemption...." Tri-States Double Cola Bottling, 706 N.E.2d at 283. The Department does not disagree that the Department has determined that refrigeration equipment may be entitled to the exemption; the Department has agreed that Taxpayer's "work-in-process" cooler is entitled to that exemption. However, the Department is unable to agree that the Taxpayer's "finished goods" cooler causes a "substantial change" in the "form, composition, or character" of Taxpayer's food product. 45 IAC 2.2-5-8(k). Based upon the information offered by Taxpayer and the information contained within the audit report, the "finished goods" cooler maintains Taxpayer's food product in a form satisfactory to Taxpayer and Taxpayer's customers but does not have a direct effect on that product changing the form and composition of that product.

FINDING

Taxpayer's protest is respectfully denied.

II. Evaporation Equipment – Gross Retail Tax.

DISCUSSION

Taxpayer purchased evaporation equipment which it originally explained is "used to evaporate moisture from the air and product." Taxpayer further explained that this equipment "allows [its] product to stay fresh by lowering the temperature of the product, thus helping to preserve the product until such time it can be fully frozen." Taxpayer cited to 45 IAC 2.2-5-8(c) as authority for its position that the evaporation equipment is exempt. The regulation states as follows:

> The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

The audit report stated that the evaporators are "used as part of the cooling system at [Taxpayer's] plant [and] are used in all air conditioning systems to remove moisture." The audit noted that the evaporators do help to keep moisture out of the plant but disagreed as to the applicability of the exemption stating that "there was no positive causal effect on tangible personal property." The audit found the evaporation equipment was subject to tax pursuant to 45 IAC 2.2-5-8(j) which states as follows:

> Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading. (Emphasis added).

The June 2011 Letter of Findings disagreed with Taxpayer's analysis as follows:

> [Indiana Dep't of Revenue v. Kimball Int'l, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988)] and the Department's Letters of Findings which have addressed this particular issue suggest two elements for obtaining a sales tax refund under the manufacturing exemption. First, the ventilation or air conditioning must play an active and integral role in the manufacturing process. In other words, but for the use the Taxpayer's evaporators, the manufacturing process would be impossible and a final marketable product would not be produced. See Letter of Findings 04-20050063 (May 22, 2006); Letter of Findings 04-20020168 (May 29, 2003). While using the evaporators can be an element of the manufacturing process, merely managing or conditioning the air environment of an entire plant, by itself, is not manufacturing. Second, only clearly demarcated areas in which there is active manufacturing that depends on a controlled environment are entitled to the exemption. For example, paint booths or finishing stalls within a plant are such areas. The mere fact that the food processing occurs within an open area of a plant does not mean the evaporators are exempt, unless the size and volume of the manufactured product is so large as to dwarf the plant and render the whole interior an integral part of the processing facility. In Taxpayer's facility, the evaporators operate to "condition" the environment within that facility rather than a specific, demarcated area within that facility.

Taxpayer disagrees with the foregoing analysis stating that "[t]he [Letter of Findings] uses a parsed sentence

from the Kimball opinion as its basis for denying the Taxpayer's protest." Taxpayer maintains that, "If the environmental equipment has a purposeful effect on the food product, then it is an exempt part of the production process." Taxpayer also cites to the particularized qualities of the food product produced at this particular manufacturing location indicating that the moisture content of the food product is particularly critical; Taxpayer indicates that the difference between the moisture conduct of one of its food product defines that particular product. In other words, the only physical difference between one of the products produced at this particular location and another product produced at this location is moisture content. As Taxpayer explains, "Constant control of the ambient moisture content of the plant is necessary to produce the intended marketable product."

The Department continues to believe that the analysis set out in the original Letter of Findings (Letter of Findings 04-20100681 (June 15, 2011).**)** provides the correct analysis.

> While using the evaporators can be an element of the manufacturing process, merely managing or conditioning the air environment of an entire plant, by itself, is not manufacturing. Second, only clearly demarcated areas in which there is active manufacturing that depends on a controlled environment are entitled to the exemption. For example, paint booths or finishing stalls within a plant are such areas. The mere fact that the food processing occurs within an open area of a plant does not mean the evaporators are exempt, unless the size and volume of the manufactured product is so large as to dwarf the plant and render the whole interior an integral part of the processing facility. In Taxpayer's facility, the evaporators operate to "condition" the environment within that facility rather than a specific, demarcated area within that facility.

As noted in Part I above, "In applying any tax exemption, the general rule is that 'tax exemptions are strictly construed in favor of taxation and against the exemption.' Indiana Dept. of State Rev. v. Kimball Int'l Inc., 520 N.E.2d 454, 456 (Ind. Ct. App. 1988)." Taxpayer asks that the Department conclude that equipment used to "condition" the environment within Taxpayer's facility is entirely exempt, but the Department must respectfully decline that invitation. The Department believes that its interpretation and application of 45 IAC 2.2-5-8(c) is such a "narrow interpretation" of the exemption that it ignores "the intent of the legislature embodied in a statute...." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct.1991).

However, Taxpayer raises an additional issue related to the evaporation equipment. Taxpayer explains that this equipment is part-and-parcel of the refrigeration equipment addressed in Part I above finding that Taxpayer's "work-in-process" cooler was exempt from sales/use tax because the "work-in-process" cooler had a direct and immediate effect on Taxpayer's food product. Presumably, Taxpayer's "evaporation equipment" consists of compressors, condensers, and the like which – in part – are integral to the function of the exempt "work in process" cooler. To the extent that Taxpayer is able to delineate the extent to which the evaporation equipment is related to the "work-in-process" cooler, the audit division is requested to adjust the sales/use tax assessment.

FINDING

Taxpayer's protest is sustained in part and denied in part.

III. Auger – Gross Retail Tax.

DISCUSSION

Taxpayer disagrees with the Department's decision concluding that its purchase repair parts for an auger were not exempt from sales tax. The original September 2010 audit found that the auger parts were not exempt because the auger was "used to move raw materials from storage tanks to the production process." In support of that decision, the audit cited to 45 IAC 2.2-5-8(d) which states in relevant part:

> "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

However, Taxpayer states that the auger is not merely moving raw materials – likely a "pre-production" step – but is moving a mixture of water, flour, ground corn, and additional ingredients." In other words, Taxpayer believes that the transport of these mixed ingredients occurs within the production process and there the auger and its repair parts are entitled to the exemption four at 45 IAC 2.2-5-8(g) which states:

> Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process.

Based upon Taxpayer's subsequent explanation, the Department is prepared to agree that the auger is "directly involved" in the "direct production" of its food product as set out in 45 IAC 2.2-5-8(b) and that the auger causes a "substantial change" in the "form, composition, or character" of Taxpayer's food product. 45 IAC 2.2-5-8(k). As to the replacement parts here at issue, 45 IAC 2.2-5-9(h)(2) provides, "Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment... are exempt from tax." Therefore, because the auger is exempt equipment having a direct effect on Taxpayer's food product, the replacement parts used to repair the auger are exempt.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest challenging the assessment of sales tax on the "finished goods" cooler is denied; Taxpayer is entitled to an adjustment of the sales/use tax assessment related to the purchase of the evaporation

equipment to the extent that Taxpayer is able to reasonably quantify the extent to which the equipment is interrelated to the function of the exempt "work in process" cooler; the purchase of the auger replacement parts is exempt.

Posted: 11/30/2011 by Legislative Services Agency
An html version of this document.